

# Economic Diplomacy and the Liberal Peace

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## **ECONOMIC DIPLOMACY AND THE LIBERAL PEACE**

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### **Abstract**

The purpose of this work is two-fold. The first is to relate the theory of liberal peace to the notion of economic diplomacy. The second objective of this essay is to relate the greater economic globalization outcome of economic diplomacy, and its counterpart liberal peace objective, to the incidence and nature of domestic conflict. Nowadays, civil war has become the dominant form of war, mainly in developing countries. But other forms of social conflict and unrest short of war are also emerging, especially in the wake of the growing global tide of rising inequality and relative deprivation since the current phase of globalization gathered pace after *circa* 1980. This is also reflected in voting in democratic countries, for example the referendum in favour of Brexit in 2016. A game theoretic model of interaction between the state and a dissident group over the degree of globalization is also presented.

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## Introduction

‘Commerce is the grand panacea’, said Richard Cobden (1835), when he alluded to the pacific and civilizing effects of international trade and its role in assuaging tensions between nations. Similarly, John Stuart Mill (1848, *Principles of Political Economy*, III.XVII.4) spoke of the ‘intellectual and moral’ benefits of international commerce. Besides preventing conflict between peoples<sup>1</sup>, it allowed society to learn from other nations leading to its advancement well beyond the mere pecuniary sphere. In contemporary political science the term liberal peace is employed to explain the absence of armed conflict between democratic nations that are also economically interdependent. The expression, liberal peace, therefore, has an economic dimension, as well as an element based on a common polity and values. Ultimately, these two strands of the liberal peace are inseparably linked; the literature on the liberal peace, however, may be dichotomised into ideal and economic theories. The ideal theory can be traced to Immanuel Kant’s notions of *foedus pacificum* (league of peace) in his essay on the Perpetual Peace (1795) where the simultaneous adoption of a republican constitution by different nations generates a cosmopolitan peace. Its modern counterpart is to be found in the contemporary philosopher, John Rawls’ (1999) ideas. Economic theories of the liberal peace probably date back to Montesquieu’s views (1748) regarding the pacific benefits of economic exchange between peoples; a review of contemporary thinking may be found in Gartzke (2007), where it is labelled the ‘capitalist’ peace.

Gleditsch (2008) has outlined a liberal ‘tripod’ where common democratic values, joint membership of international organisations and economic inter-dependence together buttress the ‘liberal’ peace. The term ‘liberal’ internationalist should be underscored in this regard, to distinguish this school of thought from ‘realist’ strands in political science and international relations. This view, in the extreme, regards nation states as existing in a state of non-contractual anarchy vis-à-vis each other, making the exercise of power, or the gathering of power by war, a calculated opportunistic act. Yet there are notions that a common set of values, and/or inter-state commerce will moderate or eliminate these war-like tendencies; see, for example, Doyle (1986).

The purpose of this work is two-fold. The first is to relate the theory of liberal peace to the notion of economic diplomacy. Economic diplomacy has been defined by Bergeijk (2009, chapter 1, page 14) as the either the use of political means to foster bilateral inter-state economic flows, or the use of economic means to promote peaceful political goals such as greater inter-state cooperation, increasing the cost of inter-state war, or to do the reverse: punish ‘errant’ nations via economic sanctions and commercial boycotts. Economic diplomacy is primarily understood to be bilateral (between pairs of nation states), but multilateral fora (the European Union is the foremost example) are also important instruments of economic diplomacy because it strengthens the institutional framework for achieving liberal peace objectives. Given

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<sup>1</sup> Advanced nations can, however, be driven by mercantalistic (monoplastic) gains from trade motives to wage war against smaller less ‘civilised’ countries, as during the colonial era. For example, Kant (1795) deplores the rapacious activities of the British East India Company in Bengal. Mill, who was as an employee of the East India Company until its abolishment in 1858, is widely regarded as a liberal imperialist, and was without doubt an advocate of British imperial expansion in the Indian sub-continent, on the grounds of *mission civilisatrice* of British rule (Tunick, 2006).

the fact that for most nation states, save the largest and economically most powerful, conduct their 'higher' trade policy governing tariffs, quotas and trade regulations via trading blocks and free trade agreements, economic diplomacy becomes more salient as it allows for more informal contact and trade promotion, during overseas visits by dignitaries, or even at the sectoral or firm level by diplomats and captains of industry.

Thus, it can be readily deduced that economic diplomacy is crucial to the construction of at least one of the pillars of the liberal peace, namely economic inter-dependence between nations. Arguably, even the construction of the common democratic values pillar of the liberal peace edifice is aided by economic diplomacy. And common membership of international organisations, an important pillar of the liberal tripod, also assists in the conduct of economic diplomacy, if only by augmenting the bargaining power of member states.

The second objective of this essay is to relate the greater economic globalization outcome of economic diplomacy, and its counterpart liberal peace objective, to the incidence and nature of domestic conflict. Nowadays, civil war has become the dominant form of war, mainly in developing countries; see, Murshed (2010). But other forms of social conflict and unrest short of war are also emerging, especially in the wake of the growing global tide of rising inequality and relative deprivation since the current phase of globalization gathered pace after *circa* 1980.

The remainder of the work is organised as follows: the next section examines theories of the liberal peace, followed by how greater economic globalization relates to internal conflict, ending with a brief conclusion. There is a game theoretic model contained in the appendix describing interaction between the state and a dissident group in the context of greater globalization and democratic values engendered by globalization (including economic diplomacy) with the goals of the liberal peace in mind.

## 1 Theories of the Liberal Peace

Immanuel Kant in his essay on the Perpetual Peace (1795) argues that although war is the natural state of man<sup>2</sup>, peace can be established through design. This requires the adoption of a republican constitution simultaneously by all nations, which *inter alia* would check the war-like tendencies of monarchs and the citizenry; the *cosmopolitanism* that would emerge among the comity of nations would preclude war.<sup>3</sup>

Kant's (1795) essay on the 'Perpetual Peace' provides us with clues as to the nature of the republican constitution. First, observe the usage of the expression 'perpetual', implying permanence as opposed to a transient truce. Secondly, and most crucially, Kant refers to the separation of powers between the executive and legislature (this ensures their proper and efficient functioning); we may also add the independence of the judiciary. Put simply, this concept implies good government that holds the domestic social contract together. Thirdly, the stability of the peace depends upon the

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<sup>2</sup> Akin to Thomas Hobbes' conception of the non-contractual 'state of nature'.

<sup>3</sup> This could also create a confederation of nations with common values, such as with the European Union's *acquis communautaire*.

source of sovereignty or legitimate power within the nation. Although not enamoured of certain forms of rabble-led democracy, Kant nevertheless points out that good governance provided by a dictator or an absolute monarch is inherently unstable as he or his successors face temptations to deviate from good government, and the assurance of good governance is more forthcoming in a system of power that is representative of the people. Central to the Kantian republican constitution is a system of checks and balances or a separation of powers which are largely absent from the fledgling democracies that characterise the developing world at present.

Mirroring Kant's thoughts, is the contemporary philosopher, John Rawls's (1999) notion of peace between liberal societies, whom he refers to as *peoples* and not states. Rawls' Law of Peoples is inspired by Kant's *foedus pacificum* and is termed a 'realistic utopia'. There is an appeal to both natural law and the possible implementation of an ideal morality. An ideal state is *reasonable*, even if in an imperfect world it is *rational* to deviate from such optima. He speaks of well-ordered peoples. These are mainly constitutional liberal democracies, who arrive at this arrangement based on ideas of *public reason*. Rawls argues that liberal societies do not go to war with each other because their needs are satisfied, they are non-acquisitive in the sense of not wishing to grow beyond an achieved steady-state level of (presumably high) income, and they are tolerant of difference. Thus, there cannot be excessive or unacceptable inequality in such a community. They will, in theory, only fight in self-defence, and only invade to prevent gross human rights abuses such as genocide in other countries.

The liberal view that trade between nations *directly* contributes to peace harks back to the Baron de Montesquieu's, *Spirit of the Laws* (1748), where he states that commerce tends to promote peace between nations; mutual self-interest precludes war; trade also softens attitudes of peoples towards each other. The fact that commerce promotes peace was also pointed out by Tom Paine (1791-2, page 265). Similar views were aired more strongly by Richard Cobden (1835). Sir Normal Angell (1910) asserted that nations could never enrich themselves through war, and even a victorious nation would come off economically worse from a war. Angell's (1910) view about the irrationality of war between the great powers of Europe in 1910 was based on a universal notion of rationality; bounded or limited rationality can never rule out wars, especially in the presence of misperceptions such as an exaggerated view of the probability of victory. Consensual exchange or trade is the peaceful means of economically benefiting from the endowments of another country. The other means is war, representing the forceful acquisition of another country's resources—the mercantilist wars of 17<sup>th</sup> century and the various colonial wars of conquest from the 16<sup>th</sup>-19<sup>th</sup> centuries offer numerous examples of these.

Polachek (1997) made the case for the purest form of the economic liberal peace, arguing that a common polity (democracy) is largely immaterial. He presents empirical evidence to suggest that advanced democracies cooperate, not because of their similar political systems, but due to their vast and multiply intersecting economic inter-dependence. War disrupts these networks, and is therefore against the interests of the nation states who are thus connected.

While all analysts agree that war impedes trade, the 'realist' view is that countries may choose to disrupt their potential enemy's gains from trade by ceasing trading

with them, even if this means hostilities. Barbieri and Levy (1999), using an interrupted time series framework found little impact of war on trading relationships for seven dyads from 1870. They argue that any disruption to bilateral trade caused by war is, in many instances, remedied after peace emerges. Both trade and war produce winners and losers. Even if there are losses to the aggregate economy from war or diminished trade, some groups may gain, and these groups may be the more politically influential. Anderton and Carter (2001), however, dispute these findings.

Polachek and Seiglie (2006) maintain that wars and disputes between geographically contiguous states involve substantial losses, as more efficient geographically proximate trade is displaced. At the same time, the absence of trade between neighbours also increases the probability of conflict. Robst, Polachek and Chang (2007) demonstrate that geographical proximity has a greater conflict enhancing effect when two nations fail to realize opportunities for trade.

During the two world wars of the 20<sup>th</sup> century, highly interdependent economies went to total war with each other. Consequently, the economic inter-dependence argument for peace needs re-examination. Hegre (2000) argued that economic inter-dependence reinforces peace, but mainly between more developed economies. Russett and Oneal (2001) point out that it is the economic dependence on trade of the least dependent on the other member of a group of nations that will determine the pacific effect of trade.

Among the updates proposed for the liberal peace theory based on economic inter-dependence is the 'capitalist' peace notion of Gartzke (2007). He argues that the intensity of trade is only one factor in the peace engendered by capitalism. The nature of advanced capitalism makes territorial disputes, which are mainly contests over resources, less likely as the market mechanism allows easier access to resources. The nature of production makes the output of more sophisticated goods and services increasingly reliant on 'ideas' that are research and development intensive, and skilled personnel can be acquired through more open global labour markets. Moreover, the disruption to integrated financial markets makes war less likely between countries caught up in that web of inter-dependence. We are all acutely aware of how disruptive financial crises and the resultant contagion that spreads all over the world are.<sup>4</sup> Gartzke (2007) argues that common foreign policy goals reflected in the membership of international treaty organisations (NATO, the European Union etc.) also produces peace.

Dorussen and Ward (2010) rehabilitate the role of trade in engendering peace. They argue that trade has important *indirect* effects over and above the inter-dependence induced by bilateral trade. Increased trade generally, may do little to mollify war-like tendencies between a pair of countries, but if each of these countries interacts considerably with third countries, it will be not in their interests to go to war with each other, as it disrupts other links and networks. In other words, any two countries are unlikely to go to war with each other if they trade with the rest of the world is substantial even when their bilateral trade dependence is low. Murshed and Mamoon (2010) find evidence of this in their study of the effects of trade and democracy on

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<sup>4</sup> For example, the Wall Street crash of October 1929 heralded the world-wide Great Depression of the 1930s; the effects of the flawed regulation of US sub-prime lending markets produced the global financial crisis.

India-Pakistan conflict. India and Pakistan are not only hostile towards each other, but their bilateral trade is very low compared to what would be predicted by their close proximity. Multilateral trade with the rest of the world has the greatest hostility reducing effect; however, the bilateral trade between these two countries is impeded by conflict, just as the limited value of trade is conflict enhancing. **There is, however, a reverse causality here. Multilateral trade with the rest of the world reduces hostility between India and Pakistan, but their mutual mistrust and hostility attenuates their bilateral trade. Hence economic diplomacy would be useful in this context.**

This modern view of the liberal peace can be summarized as asserting that similar, contiguous democracies at a high level of economic development will not fight each other (Gartzke, 2007). Democracies may go to war with other democracies that are distantly located, culturally disparate and considerably poorer. Democracies or liberal societies that descend into poverty, or fall behind other affluent nations because of the lack of growth following systemic changes such as the collapse of socialism may turn to aggression; see Wenar and Milanovic (2009) on this. What is also required for peace in a pair-wise dyadic sense between nations is not just democracy and economic inter-dependence, but also high levels of development (Hegre, 2000), as high income nations have most to lose from war with one another. Papers by Bussman (2010), as well as Polachek, Seiglie and Xiang (2012) demonstrate using national dyads (pairs of nation states) that the stock and flow of foreign direct investment also reduces hostile behaviour (not just confined to war) between nation states.

Economic diplomacy is essential to building the pillars and achieving the goals of the liberal peace. This is so both in the bilateral sense (between pairs of nation states), as the India-Pakistan case illustrates, but also in the multilateral context. Arguably, the European Union is the international organisation par excellence in providing the mechanisms for building and strengthening all three pillars of the liberal tripod.

### **3 Globalization and Internal Conflict**

It is worthwhile revisiting the gains from trade. The static textbook gain is that international trade increases the utility of the 'representative' consumer by providing a superior consumption bundle at a better set of relative prices.<sup>5</sup> This is mainly because imported goods are cheaper compared to the autarkic situation. What are the distributional consequences of increased world trade among the various sectors of the economy? After an expansion of trade, the factors of production employed in the exportable sector will witness a rise in their remuneration. This is because the exportable sectors of the economy expand, and the import-competing sectors contract, after increased international trade. It is immediately apparent that globalization produces winners and losers.<sup>6</sup> For example, with the end of the multi-fibre agreement which governed and restricted the import of garments from developing countries into OECD nations, the remaining European Union producers (in countries like Portugal)

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<sup>5</sup> Provided that this consumer is not pauperized by the process.

<sup>6</sup> In developing countries (mainly in Asia) that have experienced an increase in their export of unskilled labour intensive goods (mainly garments) one would expect a rise in the remuneration of the unskilled relative to the skilled. But this has not happened because of the shortage of skilled personnel (as a result of low public education expenditure in the presence of a substantial military budget), and the presence of surplus labour; see Mamoon and Murshed (2008).

were hurt by Chinese exports, so they successfully lobbied for, and obtained a re-imposition of import controls. Mamoon and Murshed (2008) find evidence that trade liberalization has widened the skilled-unskilled worker real wage gap. **It may be argued that the immiserization of unskilled labour may not take place in the context of intra-industry trade expansion context (for example when France and Germany sell cars to one another), but much of the intra-industry trade today is in components of manufactured goods, where the factor proportions theories of distribution still apply.**

The question then is whether or not society is in a position and prepared to compensate the losers from increased trade. If there is economic growth following globalization the gainers gain is greater than the loss of the losers; there is a potential for compensating the losers, provided enough political will exists to affect the re-distribution. Policies that aim at greater economic integration or globalization have the potential for increasing internal conflict because they produce winners and losers, particularly if such policies are a limited success or a failure in countries that experienced stagnation and growth failure in the last two decades of the 20<sup>th</sup> century, such as in sub-Saharan Africa, parts of the erstwhile Soviet Union (Central Asian republics without oil or gas) and even Latin America.<sup>7</sup> On the other hand, the economic variant of the liberal peace argues that societies that have achieved greater degrees of openness to international trade and finance are more peaceful. How do we reconcile these two opposing forces?

Bussman and Schneider (2007) argue that policies aimed at greater globalization lead to a conflict risk increasing outcome, but highly open economies cannot sustain high levels of international trade and foreign direct investment inflows if they are in conflict, especially in the form of civil war. Indeed, they find empirical evidence to support these findings in a cross sectional econometric investigation of conflict risk.

Traditionally, economic inequality has been thought to be growth enhancing, as the rich were regarded to save more and invest in productive capacity. That view has, however, been modified in recent times especially given the growing trend for rising inequality in most countries worldwide since about 1980; see Jayadev, Lahoti and Reddy (2015).<sup>8</sup> Traditional arguments against excessive inequality were grounded in 'equity' considerations based on society's aversion to highly unequal outcomes. A modicum of unequal outcomes as a reward for differential effort, talent and risk taking can be regarded as fair, but what is both unjust and inefficient is inequality of opportunity (Roemer, 1998), which may be rooted in either systematic discrimination or unequal access to opportunities such as education. It can be argued that present day trends in the distribution of income with the accelerating share of the top 1% in the global income distribution produces inequality of opportunity and hampers inter-generational mobility, particularly because much of the wealth of the wealthiest is principally attributable to a rent earned from speculative financial investments. In the ultimate analysis, in the presence of many market imperfections, adverse selection, substantial economic rents and inequality of opportunity, the separability between the efficiency and equity arguments against inequality fall apart, but above all make social protection and redistributive policies justifiable.

<sup>7</sup> Even though growth in all developing countries picked up at the turn of the millennium, it remains to be seen if the growth is sustained after the petering out of the commodity price boom of the last decade.

<sup>8</sup> The exception seems to be in Latin America in recent years, in countries such as Brazil.



Earlier, Alesina and Rodrik (1994) showed that where there is distributive conflict between the haves and the have nots, a high degree of inequality may damage future growth prospects. Recently, Dabla-Norris et. Al (2015) and Ostry, Berg and Tsangarides (2014) show that the recent growth experiences of a cross-section of developed and developing countries suggest that excessive inequality is indeed harmful to growth prospects. This could be because greater inequality leaves economies more prone to financial crises<sup>9</sup>, greater inequality results in less human capital accumulation, and because inequality contains within it the seeds of conflict, which is harmful for growth. On the causes of recent rises in income inequality, Dabla-Norris et. Al (2015) point out that unskilled labour saving technical progress, financial globalisation (but not trade openness) and less regulation of labour markets, including the informalisation of work are the chief culprits. Easterly (2007) demonstrated that a higher middle class share of income does promote growth, because the middle classes traditionally lobby for more growth enhancing public goods, including publicly funded education and health care.

In a similar vein, redistributive policies, including social protection expenditures which were earlier regarded to result in a distortionary tax burden for the economy do not seem to harm growth prospects (Ostry, Berg and Tsangarides, 2014) in recent cross-country empirical analysis. In other words, the case against redistributive policies based on the distortionary impact of the fiscal (tax, transfer) system may be invalid in the presence of excessive inequality. Hence, the well-known efficiency-equity trade-off no longer applies in recent years.

Rodrik (1999) argues that social conflict measured by indicators such as inequality, unless managed by well-functioning institutions can lead to growth collapses. In other words, persistent inequality destabilises society and the social contract; this may produce social conflict, even if it is not full-blown armed conflict.<sup>10</sup> He also argued (Rodrik, 1998) that more open or more globalised economies need to have greater government expenditure, including more social protection spending, in order to cushion citizens against the idiosyncratic and cyclical risks that increased exposure to world markets brings.

This leads us to the political economy considerations, as the choice and implementation of policies by the state are fundamentally the outcome of strategic interaction between different interested parties, in this case the haves and the have nots. The pressure for redistribution results in the early democratic contract (Acemoglu and Robinson, 2009) with some power transferred to the less affluent, and consequently some redistribution. Downs' (1957) famous median voter theory suggests that the median voter's preferences will prevail in a democracy. Meltzer and Richard (1981) suggest that increases in the size of government in democracies are due to either the extension of the franchise (which lowers the median voter's mean income), or if economic growth makes the increased per-capita income greater than that of the median voter, who will prefer more government social sector expenditure. But the median voter's interests seem to be overridden by the economic interests of

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<sup>9</sup> This is because the extremely wealthy demand a high return to their financial investments, and the financial debt burden of the relatively poor if securitized can make economies more prone to financial crises, which in turn can cause major recessions.

<sup>10</sup> Inequality between distinct ethnic groups, a concept known as horizontal inequality, can be a major cause of civil war; see, for example, Murshed (2010), chapter 3.

the rich and powerful who value social protection much less, and are in favour of its private provision so as to further enrich themselves. This is precisely what has occurred in most high and middle income countries in recent years where mean income has risen relative to median income, implying greater inequality. There has been greater globalization, economic diplomacy and the objectives of the liberal peace between nations have been met, but at the cost of greater inequality and domestic social cohesion. The remedy lies in greater social protection. In recent times, the greatest body blow to the goals of the liberal peace was rendered by the outcome of the British referendum to leave the European Union where 51.9% of those who cast ballots voted to leave, and the preliminary analysis of the leave vote suggests that the those with below mean incomes: the marginalised, less educated and unskilled production workers were most likely to vote leave. For example, Uberoi (2016) indicates that there is a statistically significant positive correlation between the proportion of non-graduates (unskilled workers) and the leave vote based on the data for electoral districts for this referendum. Similar, arguments can be made in the case of the rejection of the EU-Canada trade by the relatively poorer Walonian part of Belgium, and even in the Dutch referendum which rejected the treaty with Ukraine.

#### **4. Conclusions**

The liberal view is that peace is engendered by common values and peaceful economic exchange. When it comes to interaction between nation states since the late 19<sup>th</sup> century, common democratic values and greater commerce can achieve peace, albeit with notable exceptions as during the Great War of 1914-1918. But the goals of the liberal peace require mechanisms for achieving its ends. Economic diplomacy is a powerful means of achieving that liberal peace end, mainly in the bilateral sphere. It is also a means of supplementing formal trade agreements via informal means. In other words, economic diplomacy is the chief instrument of the liberal peace in the inter-state sphere. But multilateral mechanisms in the shape of international associational organisations are the third, and arguably, most important pillar of the liberal peace. The chief example of this is the European Union with its economic, political, social protection, educational, scientific and security agendas for cooperation. Economic diplomacy still has a place within the Union, as groups or nations can lobby decision makers, and the economic diplomacy conducted between trading blocs is of great importance to member states of the European Union. The bargaining power of all but the very few larger nations of the world are enhanced and best served in bilateral negotiations between economic or trading blocs.

The liberal peace, along with its chief instrument economic diplomacy, has been a remarkable success in the inter-state sphere. Where the corollary of the liberal peace in the form of free trade has been found wanting is in connection with the growing inequality that has gathered pace along with accelerated economic globalization since 1980. Thus, although average incomes may increase as a consequence of greater globalization, the median household's income may have fallen relative to the mean. This inequality destabilises society, and in some cases can contribute to outright civil war. The answer lies in greater social protection expenditure, which is much less distortionary than previously thought. Redistribution will help to serious inter-generational inequalities of opportunity, as well as constituting a potential Pareto improvement in social welfare, as the gainers from globalization are well positioned to compensate the losers through the fiscal (tax) and public spending mechanisms.

Perhaps, the greatest setback to the liberal peace in recent times is the British referendum result in June 2016 calling for the UK's withdrawal from the European Union.<sup>11</sup> Nor does it make sense from an international *realpolitik* standpoint. The misguided median voter may have thought that Brexit would release more resources for domestic social expenditure and redistribution, which is unlikely in the prevailing privatised and managerial model of providing public services. The average leave voter may also have implicitly believed that restricting immigration will improve the earnings prospects of unskilled (production and service sector) workers. This cannot occur without far reaching capital controls. Mundell (1957) demonstrated that the free movement of capital is sufficient to achieve factor price equalisation; hence, the wages of the unskilled are likely to remain low or fall towards the levels of their counterparts in Eastern Europe. **Also, the idea of repatriating sovereignty in an age when national sovereignty is diminishing is also chimerical.**

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<sup>11</sup> One is reminded of the British Foreign Secretary, Sir Edward Grey's words on the eve of the British declaration of war on Germany on 3<sup>rd</sup> August 1914: 'the lamps are going out all over Europe, we shall not see them lit again in our lifetime'.

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## **APPENDIX: GLOBALIZATION, DEMOCRACY AND INTERNAL CONFLICT**

The model below is closely related to the model in Murshed and Mamoon (2010). There are two opposing groups, which for the sake of convenience, we refer to as the government and the dissidents or rebels, although the opposition group may not be engaged in armed conflict with the state. The two groups are indexed by subscripts  $G$  and  $R$  respectively. The government refers to the ruling classes, and the dissident groups are the proscribed, excluded or marginalized. Inequalities in income, wealth, education, health status, political influence, and above all enduring inequalities of opportunity divide the two groups. In some societies open war characterises their antagonism, in others violent clashes are the form their confrontation takes, and in still others the deep resentment of the economic and political inequalities between the two groups leads to mainly non-violent protest. The conflict between the two groups may be episodic, but the antipathy is omnipresent, and the material chasm between the haves and have nots enduring.

Imagine two states of nature, denoted by superscripts: one more peaceful or dovish ( $D$ ), and the other associated with greater hawkishness ( $H$ ). The former is characterised by less confrontation between the two groups and the rulers attempt to mollify the disadvantaged. The probabilities of the two states are defined to be  $\pi$  and  $1 - \pi$ , respectively. The probability of either state is in turn affected by actions and efforts; ( $a$ ) for the government and ( $e$ ) for the rebels or dissidents. These are also the strategic variables employed by the two sides in their strategic interaction with each other. The probability of the peaceful state  $\pi$  rises with the input of action and effort by the two sides, but at diminishing rates.

Interestingly, the two strategic choice variables are in the inverse of conflict, as they pertain to peaceful behaviour. One can imagine a range of activities by one or both sides if they wish to promote peace, including a greater willingness to compromise, promote inclusion and devote more resources directed towards peaceful economic development or social protection by the government and so on.

Actions and efforts to seek peace entail costs for each party. The costs of actions to promote peace can take a variety of forms; among them there is the loss of face to either party's own hawkish political constituencies simply for appearing to capitulate. Increased globalization may, however, augment the stock of rhetoric available to leaders who wish to push their 'peace' agenda through the political process. Secondly, and in a more palpable sense, increased international economic interaction, and the growth it brings, may provide the additional resources to buy off domestic 'war' lobbies. A more democratic government, in developing countries, may use its mandate from the people to justify greater peace, social protection expenditure and reduced military spending. Even in more established democracies, greater democracy, as modelled below, leads to more social protection expenditure, which raises the probability of peace.

The expected utility of the government is given by

$$U_G = \pi(a, e)U_G^D(E_G^D + S_G^D) + (1 - \pi)(a, e)U_G^H(E_G^H + S_G^H) - Z(a(T, P)) \quad (1)$$

Where  $U_G^D$  and  $U_G^H$  denote utilities or pay-offs in dovish and hawkish states respectively, weighted by the probabilities of the two states.  $E_G^D + S_G^D$ ,  $E_G^H + S_G^H$  indicate the exogenous pair of payoffs from non-security related public consumption<sup>12</sup> and security expenditure respectively in the less belligerent and more belligerent states respectively. The difference is that in dovish state security spending is lower and public consumption higher than in the hawkish state. Most importantly, the dovish state of nature will imply greater poverty reduction, leading to lesser future inequality and grievances on the part of the excluded.  $Z$  is the cost function of undertaking the action,  $a$ . Action,  $a$ , increases the probability of peace,  $\pi$ , however, undertaking it entails a cost, as described above.  $T$  indicates greater globalization (more trade with the rest of the world, greater inward investment from abroad as well as other financial flows), and this is postulated to reduce the cost of making peace via the cost function ( $Z$ ) as discussed above,  $Z_{a1} < 0$ , but so does a hybrid concept called increased democratisation ( $P$ ) for the government ( $Z_{a2} < 0$ ), as more democratic governments are clearly mandated to make peace and spend more on poverty and inequality reduction. Also,  $\pi_a > 0$ , but  $\pi_{aa} < 0$ ; there are diminishing returns to these actions. Both  $Z_a > 0$  and  $Z_{aa} > 0$ .

Turning to the rebels or dissidents, we symmetrically have

$$U_R = \pi(a, e)U_R^D(E_R^D + S_R^D) + (1 - \pi)(a, e)U_R^H(E_R^H + S_R^H) - L(e(T)) \quad (2)$$

$L$  is the cost of effort,  $e$ , which increases the probability of peace,  $\pi$ . As with the government, greater globalization may lower the marginal cost of making peaceful concessions, but it may harden grievances if greater globalization impoverishes this group and produces greater inequality as it has done in most countries, developed and developing; therefore,  $L_{e1} < ?$ . Also,  $\pi_e > 0$ , but  $\pi_{ee} < 0$ ,  $L_e > 0$ , and  $L_{ee} > 0$ .

In the non-cooperative Cournot-Nash game each side maximises its own utility function above with respect to its own choice variable  $a$  and  $e$ ; in effect equating the marginal benefit of its strategic action on the left hand side with its marginal cost on the right hand side:

$$\pi_a [U_G^D(\cdot) - U_G^H(\cdot)] = Z_a \quad (3)$$

and

$$\pi_e [U_R^D(\cdot) - U_R^H(\cdot)] = L_e \quad (4)$$

<sup>12</sup> Public consumption can include health, education expenditure, social security spending and programmes related to poverty reduction.

Greater globalisation via successful economic diplomacy changes the marginal cost of peaceful behaviour ( $Z_{a1}$ ,  $L_{e1}$ ). Analytically this means a change in the first-order conditions for both sides to:

$$\pi_a [U_G^D(\cdot) - U_G^H(\cdot)] = Z_{a1} dT \quad (5)$$

$$\pi_e [U_R^D(\cdot) - U_R^H(\cdot)] = L_{e1} dT \quad (6)$$

This pertains to the trade effects of the liberal peace. For the government side, the cost of making peace declines on the right hand side of (5) as  $Z_{a1} < 0$ . But for the rebels, if they are disadvantaged by globalization, the costs could rise in (6) and  $L_{e1} > 0$ . There could be greater conflict, unless globalization is broad based enough to also advantage the rebels. The costs of peaceful actions may also be easier to bear if the government becomes more democratic, causing the first order condition for the government to become ( $Z_{a2} < 0$ ):

$$\pi_a [U_G^D(\cdot) - U_G^H(\cdot)] = Z_{a2} dP \quad (7)$$

Note that in Equations (3) and (4) each side will equate its marginal benefit from exercising their own strategic choice to the corresponding marginal cost. Each side's strategic choices will depend on the first order conditions given in Equations (3) and (4), along with a fixed conjecture about the opposition's strategic choice. These lead to the (linear) reaction functions for both sides, obtained by totally differentiating Equations (3) and (4) with respect to  $a$  and  $e$ . For the government this is indicated by

$$\frac{de}{da / R_G} = \frac{Z_{aa} + \pi_{aa} [U_I^H(\cdot) - U_I^D(\cdot)]}{\pi_{ae} [U_I^D(\cdot) - U_I^H(\cdot)]} \begin{matrix} \geq \\ \leq \end{matrix} \dots 0 \dots \text{if} \dots \pi_{ae} \begin{matrix} \geq \\ \leq \end{matrix} 0 \quad (8)$$

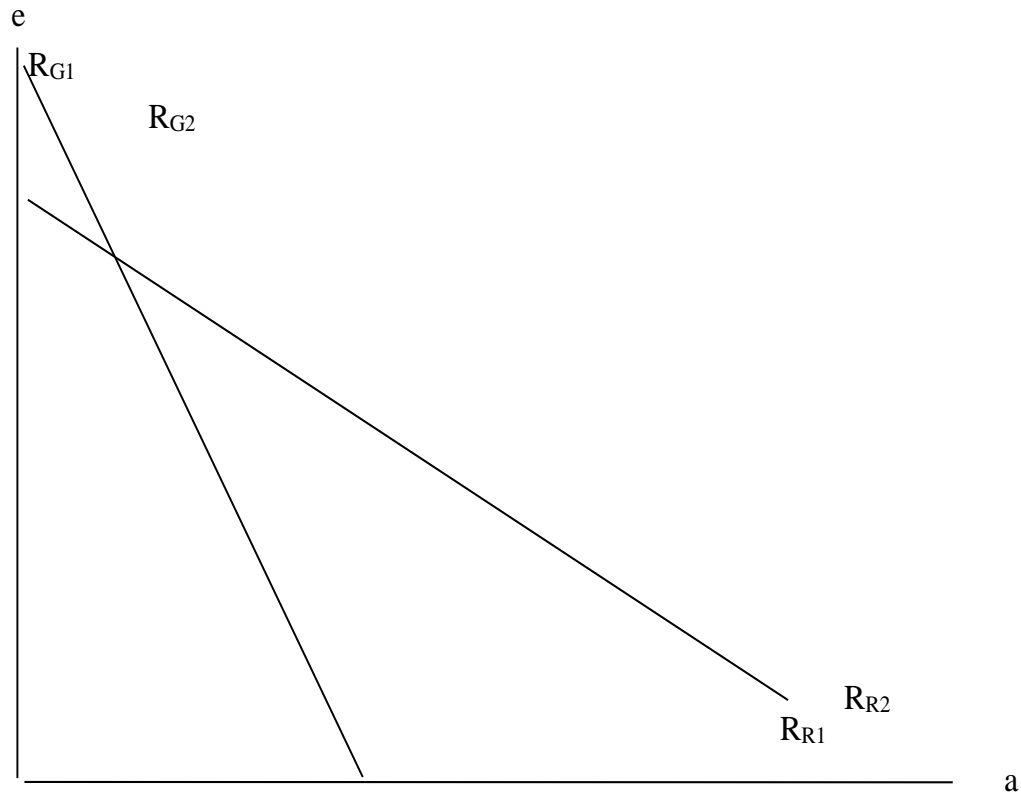
and for the rebels and dissidents by

$$\frac{de}{da / R_R} = \frac{\pi_{ae} [U_P^D(\cdot) - U_P^H(\cdot)]}{L_{ee} + \pi_{ee} [U_P^H(\cdot) - U_P^D(\cdot)]} \begin{matrix} \geq \\ \leq \end{matrix} \dots 0 \dots \text{if} \dots \pi_{ae} \begin{matrix} \geq \\ \leq \end{matrix} 0 \quad (9)$$

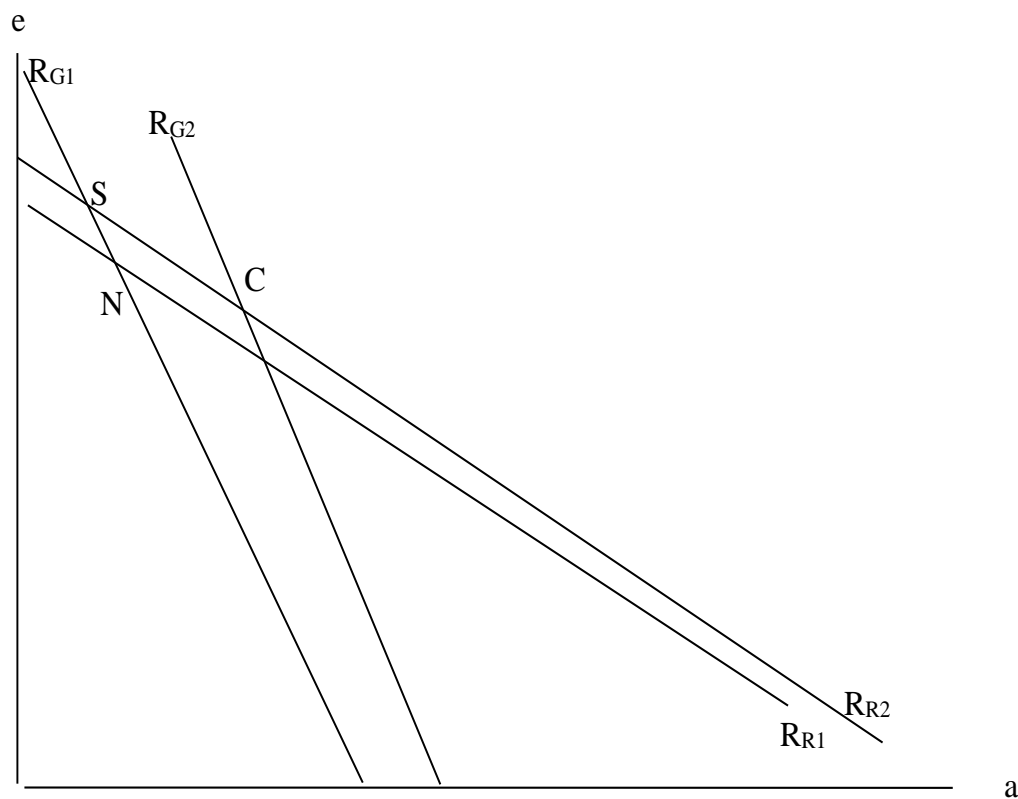
Note that  $\pi_{ae} = \pi_{ea}$  by symmetry.

The reaction functions are positively sloped if  $\pi_{ae} > 0$ , implying that the two strategies are complements. This is the standard assumption in the literature on conflict. In our model, however, we postulate that  $\pi_{ae} < 0$ , the choice variables are strategic substitutes, and the reaction functions slope downwards (Figure 1). This can occur because the strategy space is defined in terms of peace; see Murshed (2010). **The idea is that the stronger side can free ride on the activities of the weaker side. The latter group has to do more to achieve the Pareto optimal outcome, and consequently incurs more costs---hence the stronger side free rides on the weaker party.** Thus, if one side behaves more peacefully it increases the utility of both parties and the other side may free ride on this action by not bringing about a corresponding increase in their action.



**Figure 1: Reaction Functions for Government and Rebels**

In Figure 2, two non-cooperative equilibria are illustrated by points N and C respectively. Point C is more cooperative and peaceful with greater inter-country trade, less inequality and poverty reduction. A shift from N to C can occur because of greater globalisation (rise in  $T$ ) because of, say, the establishment of a free trade area after a successful episode of economic diplomacy, and increased international (not necessarily just bilateral) trade lowers the marginal cost of peaceful behaviour for both sides domestically if it is inclusive ( $Z_{a1}, L_{e1} < 0$ ). Analytically, this follows the changes denoted in (5) and (6) above.

**Figure 2: Comparative Statics**

Conversely, a movement from C to N could represent more inward looking behaviour by both domestic parties in a retreat from globalization by reneging on earlier multilateral economic agreements. A contemporary example is Brexit, or the British desire to leave the European Union. Here the median voter, whose income was below the mean, making him a member of the dissident group was given a chance to retreat from globalization given his imperfect perception about his improved prospects in a less globalised economy. Mundell (1957) showed that as long as one factor of production, say capital, is internationally mobile, factor price equalisation can take place; British low-productivity and low-skilled wages may be driven down to levels of Polish wages in the same sectors, even if Polish workers are not permitted to work in Britain.

Another possibility is a movement from N to S, where greater globalization is accompanied by more peaceful efforts by the dissident or excluded group---and where the government side could be said to free ride on the dissident's efforts to achieve more peace. This might reflect less worker rights, reduced social protection, lower taxation for the rich, all accepted by the disadvantaged segment of society in return for an illusory promise of greater fruits of globalization in the distant future, as witnessed in many developed and some developing countries in the last quarter of a century, as the median voter acquiesced to government expenditure cuts and greater wage restraint.